

R E P O R T
ON THE
VISIT TO CHINA
OF THE
SENATE DELEGATION LED BY
SENATOR JOHN HEINZ

EXPLORATION OF THE CONDITION OF DIPLOMATIC AND ECONOMIC
RELATIONS BETWEEN THE UNITED STATES AND THE PEOPLE'S
REPUBLIC OF CHINA



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THE VISIT TO CHINA OF THE SENATE DELEGATION LED BY SENATOR JOHN HEINZ

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Mr. HEINZ, from the Committee on Banking, Housing, and Urban
Affairs, submitted the following

REPORT

TO THE

UNITED STATES SENATE

OVERVIEW OF DELEGATION VISIT

A Senate delegation led by Senator John Heinz, Chairman of the Banking Committee's Subcommittee on International Finance and Monetary Policy, visited the People's Republic of China from May 23 to June 1, 1986. The delegation included Senators Bill Bradley, Paul Sarbanes, and Paul Trible and sought to investigate the following issues.

The convergence of economic and strategic interests between the United States and China, including shared strategic objectives with regard to the Soviet Union and expanding trade and investment.

China's ambitious economic modernization program, physical and policy constraints facing the country, and the likelihood of a sustained political commitment to open economic policies.

The U.S. role in supporting modernization and the climate for U.S. trade and investment in China.

Potential sources of friction in Sino-American trade and economic relations.

The delegation's visit was hosted by the Chinese People's Institute for Foreign Affairs (CPIFA).

In order to gain exposure to the widest range of opinion on these issues in the time available, the delegation travelled to seven cities in north, central and southern China, and met with central government policymakers, local officials, and line managers of production facilities.

The delegation arrived in Beijing on May 23 and received a formal welcome to China from His Excellency Han Nianlong, President of CPIFA, and Madame Zhu Man Li, Deputy Secretary General of the Institute. An introductory briefing on the full range of U.S. political, military, and commercial relations with China was provided by U.S. Embassy staff at the home of Charge d'Affaires Peter Tomsen.

On Saturday, May 24, the delegation met with Mr. Bu Ming, Chairman of the Board of the Bank of China, who provided a financial overview of the Chinese economy along with his views on economic modernization and policy reform. In the afternoon, Xu Xin Deputy Chief of the General Staff of the People's Liberation Army discussed the Soviet threat in Asia, current Chinese military policy, and areas of disagreement in strategic policy between China and the United States.

On Monday, May 26, the delegation met with Mr. Jia Shi, President of the China Council for Promotion of International Trade (CCPIT), for a discussion of Sino-American commercial relations including problems in the investment regime and bilateral trade issues. This was followed by a meeting in the Great Hall of the People with Vice Premier Li Peng, the most senior Chinese official on the itinerary, during which he provided a broad overview of China's foreign policy including points of convergence and divergence between the United States and China. Next the delegation met with Vice Minister of Foreign Affairs Zhu Qizhen, the official responsible for Sino-American relations, and examined prospects for closer bilateral relations. Finally, discussion returned to bilateral trade and investment issues in a dinner meeting with Mr. Lin Hanxiong, Minister of the State Administration of the Building Materials Industry, and Qian Qichen, Vice Minister of Foreign Affairs.

On Tuesday, May 27, the delegation left Beijing and flew to Inner Mongolia. The day was spent touring the tank production facilities at the Inner Mongolia Number One Machinery Plant in Baotou and meeting with municipal officials. At the factory, the Director, Mr. Zhang Jun Ju, explained the plant's operations and conducted a tour of tank and rail car production lines. The delegation then met with Baotou Deputy Mayor Zhang Zhiyu for a discussion of economic development and the modernization program in Baotou before departing for Xian, the old imperial capital of central China.

On Wednesday, May 28, the delegation visited the Lishan Microelectronics Company, a major high technology research and production facility. Mr. Yang Li Qan, President, and Mr. Huang Chang, Chief Engineer, provided an overview of Lishan's training and research programs; then Mr. Huang, a U.S. trained scientist, led a tour of the semiconductor manufacturing facility and discussed the impact of Western export controls on Chinese technological development.

On Thursday, May 29, the delegation departed Xian and flew to Shanghai. U.S. Consul General Thomas Brooks and his staff provided an overview of the Shanghai economy and U.S. business involvement there and a tour of the commercial district.

On Friday, May 30, the delegation had a full day of meetings beginning with a visit to the Xin Zhonghua Machinery Factory, producer of orbital rocket launchers and of refrigerators for the mass market. A briefing was provided by the Director, Mr. Zhang Wen Zhang, assisted by Madame Huang Zhong Qi of the Shanghai Bureau of Astronautics. In the afternoon, the delegation divided into two groups, with part visiting the Hudong Shipyard for a briefing and tour by the shipyard's Director, Mr. Li Quing Ke, and the others meeting with Mr. Jin Zhuqing, Director of the Shanghai Municipal Science and Technology Commission, who provided insights on development plans and government investment goals in Shanghai. A reception at the U.S. Consulate provided an opportunity to discuss the investment climate with members of the American business community in Shanghai. Finally, the delegation met with Vice Mayor Li Zhaoji of the Shanghai Municipal People's Government and Mr. Sun Gengduo, Vice Chairman of the Finance and Economy Committee of the Shanghai Municipal People's Congress to discuss local development issues.

On Saturday, May 31, the delegation travelled by train to Hangzhou where meetings were held with Mr. Wang Hongyi, Vice Secretary General of the Zhejiang Provincial People's Government, and His Excellency Xin Qichao, Vice Governor of Hangzhou, on investment and economic policy issues in the region and the city. The night was spent in Guangzhou and on Sunday, June 1, the delegation departed by train for the Shen Zhen Special Economic Zone bordering Hong Kong.

Mr. Jim Xipei, Vice Mayor of Shen Zhen, provided a briefing on developments in the Special Economic Zone and a tour of the city, following which the delegation crossed the border into Hong Kong. In Hong Kong, Mr. Burton Levin, U.S. Consul General, hosted a reception at which the delegation was briefed by Consulate staff and the U.S. business community on China trade. The delegation departed Hong Kong late in the evening and arrived back at Andrews Air Force Base on June 2.

The trip was flawlessly managed by the delegation's Chinese hosts, U.S. diplomatic personnel in China, military personnel accompanying the delegation and at refueling stops in Alaska and Japan, and administrative staff of the Senate. The journey provided a wealth of insights on Sino-American relations to the participants which are summarized below.

CONVERGENCE OF UNITED STATES AND CHINESE INTERESTS

The U.S. Government characterizes Sino-American relations as between friendly, non-allied states, in recognition of China's independent foreign policy that avoids alignment with either super power. The delegations's discussions confirmed that there are many issues on which the two countries share a common viewpoint but also that the Chinese differ with U.S. policy in certain areas. The Chinese tended to emphasize to their American audience the threat of Soviet expansionism and the need for both the United States and China to closely monitor Soviet actions in Asia and stand ready to counter aggression. On international issues concerning Central America, the Middle East, and terrorism, the Chinese

championed the interests of developing countries by arguing that the United States, like the Soviet Union, should not interfere in the affairs of sovereign states.

Despite these differences and the previous estrangement between the Beijing government and the United States, current friendly relations are supported by a considerable reservoir of good will between the peoples of the two countries. U.S.-educated Chinese and the large overseas Chinese population in the United States provide natural links. In addition, the United States was credited with only a limited role in the unequal economic relationships forced in China by Western colonial powers during the nineteenth and early twentieth centuries.

The PRC officials expressed the strong interest of the Chinese government in maintaining good political relations and expanding economic ties. The Chinese repeatedly stated that they look to Western technology as an essential ingredient of their ambitious modernization plans. American computer technology was clearly favored by the industrial managers with whom the delegation spoke, and English is the favored foreign language in the Chinese education system by a wide margin.

Particularly noteworthy was the fact that the Taiwan issue was raised only once during the visit. While described as a major stumbling block for future Sino-American relations in the delegation's opening meeting, the failure of senior military or civilian officials to even mention the issue appears to indicate that the Chinese will not let U.S.-Taiwan relations stand in the way of expanded PRC access to U.S. trade and investment.

The delegation echoed the sentiments of the Chinese government on the desirability of closer Sino-American relations, but pressed the Chinese for evidence with which to reassure skeptical Americans on the likelihood of long-term convergence of political and economic interests between the People's Republic of China and the United States. The discussions focused most often on the political posture of China vis a vis the Soviet Union and the United States and the state of economic relations with the U.S.

Soviet Union

Considerable attention was focused on the state of Sino-Soviet relations. The Senators questioned PRC officials on the significance of recent signs of easing of tensions between the Chinese and Soviets including the signing of a new trade agreement and expanded cultural ties. The Chinese were asked how relations could be improved in the face of clear Soviet expansionism threatening to China's interests in Afghanistan, Vietnam, Mongolia, and North Korea.

As a starting point, Chinese officials argued that close ties with the Soviets following the Revolution were driven primarily by Chinese isolation imposed by the West rather than a special affinity for the Soviets. PRC officials pointed to a long history of mistrust between China and Russia dating from the czarist period, and claimed that fundamental interests rather than social systems are the most important underpinnings of relations between states. They reassured the delegation that China knew very-well the things of which the Soviets were capable from first hand experi-

ence and China was not likely to ally herself with the Soviet Union.

Their argument in support of improved Sino-Soviet relations was simply that world peace was best served by relaxation of tensions among states. While the Chinese continue to distrust the Soviets, the two countries share a 7,000 mile border and must work to ease tensions in the interest of peace.

They argued that the principal goal of expanded economic ties with the Soviet Union is modernization of the more than 130 industrial plants built by the Soviets during the 1950s and now in desperate need of technical upgrading. In any case, expanded trade along these lines would only reduce the current PRC trade surplus with the Soviet bloc (with no effect on foreign exchange because of the clearing account system used) and would little alter the heavy concentration of Chinese trade in Western markets (East bloc trade is 10 percent of China's total). In addition, China's greatest need is advanced technology for which it looks almost exclusively to the West; the Soviets clearly had little credibility in this area.

Trade and investment

The Chinese welcome the expansion of U.S. trade and investment in China and point to it as the clearest sign of expanding ties between our countries. The United States is China's third largest trading partner and second source of direct investment after Hong Kong. Total trade has grown rapidly, rising more than 40 percent over the last four years to \$8.1 billion in 1985. Total U.S. investment in China stands at roughly \$1 billion.

The Chinese are anxious for closer economic ties but attempt to place the burden for more vigorous efforts on the American government and business community. Their arguments are laced with claims about the disproportionate advantages enjoyed by the United States in bilateral relations, supported by misleading and incomplete bilateral trade statistics that exclude all exports to the U.S. through Hong Kong and thereby turn a slight surplus for China into an annual deficit of roughly \$1 billion.

The Chinese take the view that Western businessmen are missing a great opportunity by not investing in China. They constantly downplay the difficulties of operating a business there. In the trade area, supported by their claims about a bilateral deficit for China, the Chinese argue that the only problems are on the side of Chinese exports (principally textiles) which are tightly controlled by the U.S. Only if Chinese exports grow can their imports grow, expanding Western opportunities to export to China. The key to expanded trade, in their analysis, is removal of U.S. trade restrictions.

The particular strength of the U.S. position in China is the willingness of U.S. companies to undertake joint ventures despite considerable difficulties in establishing themselves and high start-up costs. The Chinese attitude toward the United States was in sharp contrast to their view of Japan which was characterized as wanting only to sell, never to share production capabilities or transfer technology or skills. Over the long run, the willingness of U.S. firms to bear these start-up costs in China and persevere in working with

the Chinese offers promise of strong economic ties between the two countries.

THE DRIVE FOR ECONOMIC MODERNIZATION

The long-term prospects for Sino-American economic ties depends much more on the Chinese than on the United States. Despite an attitude expressed by many senior Chinese officials that U.S. firms were missing a great opportunity if they did not invest in China, Chinese economic policies, the level of development in the country, and limitations of infrastructure and manpower represent daunting obstacles to an expanded U.S. role in the Chinese economy.

Deng Xiano Ping has set the economic goals of roughly tripling China's real GNP to \$1 trillion by the year 2000. China must improve on its average 6-7 percent growth over the last 10 years if it is to reach this goal and the country faces a range of political and economic problems that make that outcome problematic. To address these constraints, the PRC government launched an ambitious economic policy reform program.

The Modernization Program

The Chinese have set out a program of Four Modernizations to guide future economic policy. The order of priority assigned to economic modernization places agriculture first, followed by industry, science and technology, and finally defense. Officials noted a number of indicators of the changes that have occurred.

Central planning has been reduced from specific production targets to only general guidelines. Enterprises are increasingly permitted to go into production of new types of goods to meet market demand at the discretion of enterprise managers, resulting in shifts of production from planned output of military or heavy industrial goods into civilian and consumer products: tanks to railway cars in Baotou, rockets to refrigerators at Xin Zhonghua.

Concepts like self-management and retentions of profits are being introduced into enterprise management. Instead of turning over all production and profits to the state, managers are now called upon to meet demand and to turn over part of profits in the form of taxes, using new profits for reinvestment.

The commercial sector is no longer the exclusive province of the state. Private entrepreneurs are permitted to start businesses and a state production plan has been replaced by a system based on supply and demand.

Many new, young managers with at least secondary-level technical training have been put in place, replacing party cadres with little training. Since the reforms began in the heavy industrial city of Baotou, for instance, the average age of managers has dropped from 50 to 45 and the prevalence of managers with secondary level technical training or above has increased from 10 percent to 60 percent.

A system of reward and punishment for workers has been introduced providing monetary incentives for good workers and demotions and "lay offs" for poor performers.

As to the ultimate success of economic reform, the Chinese officials repeatedly pointed with pride to the success of the rural reforms already undertaken. They noted that China feeds 20 percent of the world's population with only 7 percent of total arable land. They pointed to expanded availability of fresh fruits and vegetables, the growth of free markets in rural areas, and the success of incentives in spurring production.

The delegation's visit to the Shen Zhen Special Economic Zone also provided physical evidence of the steps being taken to promote a more modern economy. An impressive high rise city has sprung up in 6 years under an "open door policy" toward foreign capital and technology. The Chinese measured the Zone's success in the 4,000 contracts signed with enterprises from 15 countries totalling more than \$3 billion of investment.

However, Shen Zhen officials admitted that effort has been concentrated in completing basic infrastructure. Now the task is turning to improving the investment climate, dealing with the different management styles of China and the West, limited trade and commercial law in China, and ubiquitous shortages of trained manpower. The problems of reform in the urban setting are only now being put into place throughout the country, and the general tone of comments was that this was likely to be a more protracted and difficult process than the rural reforms.

All officials and managers with whom we spoke stressed their commitment to economic reform, referring to it as absolutely essential to attainment of overall economic goals. No one appeared to believe that consistent high growth was possible under the present system of economic organization or at levels of technology and training available within China. The delegation pressed very hard in this area in an attempt to determine the depth of commitment of senior officials to reform.

The delegation noted past examples of dramatic shifts in policy, from liberal, pro-growth policies to ideological purification. There was much discussion of the Cultural Revolution, the massive social upheaval sparked by Chairman Mao to renew the Communist revolution, and its value as a guide to the future. The Chinese tendency toward xenophobia was also discussed, a trait exhibited last year in spontaneous attacks on foreign spectators after a loss by the Chinese national soccer team to Hong Kong.

All Chinese officials we met professed a deep commitment to the new policy reforms and the opening to the outside world, a commitment based at least in part on their revulsion at the excesses of the Cultural Revolution. Two basic arguments were put forward as indications of the commitment of the Chinese people and government to change.

Every conversation on the Cultural Revolution was dotted with personal accounts of the impact of the tremendous social dislocation and economic losses of that period. The delegation's hosts argued that these events so deeply affected the national psyche that the Chinese would not let such a thing happen again; the Cultural Revolution represented a major turning point in the history of post-revolutionary China away from ideology to pragmatism.

The current leadership was taking steps to institutionalize the new order. China is assuming the responsibilities of membership in international organizations such as the IMF, World Bank, and Asian Development Bank, and has applied for membership in the GATT. Bilaterally the Chinese are signing investment treaties and trade agreements binding them to standards of performance in international dealings. Domestically, criminal and civil legal codes are being written to clarify individual rights and ensure due process.

While the evidence does argue for continued reform, it was clear from the delegation's observations and discussions that the Chinese have a very long way to go.

Physical and institutional constraints

China is a poor country. The World Bank places its GNP per capita at just over \$300, in the same category with countries such as India, Haiti, Somalia, and Sudan. At the same time, China stands in marked contrast to other countries at similar levels of development in terms of personal welfare—higher life expectancy, low infant mortality, and better nutrition—and economic and financial conditions—consistent higher growth, lower inflation, greater industrialization, a current account surplus, significant investment inflows, large foreign exchange reserves, and less reliance on concessional foreign aid.

Despite these strengths of the Chinese economy, the country shares many of the problems of low income, developing countries: a relatively small base of skilled manpower and managers, weak technological base, limited basic infra-structure, and relatively limited access to foreign exchange. All of these problems are compounded by the sheer size of China, which is the third largest country in the world after the Soviet Union and Canada and with 1 billion people, only 20 percent of which are in urban areas (compared to 75 percent and 66 percent for the Soviet Union and Canada).

Trained manpower: World Bank statistics indicate that only 35 percent of China's secondary school age group is enrolled in school and only 1 percent of the 20-24 age group is enrolled in higher education. The Chinese repeatedly emphasized their shortcomings in this area and the importance of higher education opportunities for Chinese students in the U.S. (the State Department reports about 15,000 students currently in the U.S.). In addition to engineers and scientists, it was clear that trained managers are badly needed as few enterprise managers seemed to have even rudimentary understanding of finance, cost accounting, or productivity analysis.

Technological base: Much Chinese heavy industry dates from the 1950s when the Soviets helped the Chinese build more than 130 factories; the delegation saw a clear illustration in the Baotou tank factory. The Chinese are now looking to the Soviets to update some of these facilities, although they have already undertaken improvements through addition of Western machinery and computer technology in some cases. On the other hand, such outdated Soviet designed production facilities contrasted sharply with more modern, Western-equipped plants in Xian and Shanghai where production of advanced

electronics and rocket boosters demonstrated Chinese capability to carry off modern and relatively sophisticated production, albeit on a small scale.

Infrastructure: The limitations facing Chinese are fairly evident and often cited by the Chinese in discussion. For example, it was noted that China is physically slightly larger than the United States but has a rail network only one-sixth as large. The delegation travelled on the single track connecting the key port city of Guangzhou and the gateway to Hong Kong at the Shen Zhen Special Economic Zone.

Foreign exchange: China's ability to earn foreign exchange is limited by the heavy concentration of exports in textiles, petroleum and petroleum products, and other primary commodities (the top three categories of exports to the United States). Expanded export of textiles is limited by quotas under the Multi-Fiber Arrangement (at least until recently a major exception in general being the United States) and prices of petroleum and primary commodities generally are since debt service is currently 7-8 percent of exports and Chinese policy is to limit the debt service ratio to 85 percent. However, the Chairman of the Bank of China made clear that until China has floated bonds and CDs in Japan and European markets, the government is wary of taking on substantial exchange risk and is likely to be cautious in increasing its exposure.

Policy constraints

Despite the strides being made by the Chinese government to reform the economy, government financial and social policies remain at least as great a constraint on development as the physical limitations facing the country. Two key problem areas are foreign exchange management and the labor and social welfare systems.

Limits on convertibility of Chinese currency have been the subject of extensive discussions between U.S. and Chinese officials. Chinese policy on foreign exchange is that foreign currencies are a scarce resource that must be used first to meet the needs of the state. To that end, the Bank of China maintains control over exchange flows, including routine conversion of currencies and repatriation of profits, although the degree of control varies with the policy climate and the prevailing level of foreign exchange reserves in the country. The Bank's Chairman cited the rapid loss of foreign exchange that occurred when central controls were loosened in 1984-85. China ran a record \$14.9 billion trade deficit and reserves fell dramatically. The World Bank estimate of external reserves as of 1984 was \$22 billion, and Chairman Bu indicated reserves now stood at \$12 billion.

The arrangements for repatriation of profits are the subject of an individual deal made with each venture. In terms of general guidance, the Bank of China has recently promulgated rules linking repatriation of profits to foreign exchange earnings.

Enterprises that earn sufficient foreign exchange from exporting to cover their profits can repatriate those profits—the key is maintaining a positive foreign exchange balance in overall operations. Sale of manufactures abroad and a 1.8 mega-

watt nuclear plant with planned energy sales to Hong Kong (now under construction) were cited as example.

Ventures producing for the domestic market but which substitute directly for hard currency imports can also repatriate profits. Armand Hammer's coal mining venture in Shanxi Province was cited as an example by the Chinese.

Producers for the local market that do not earn foreign exchange cannot repatriate earnings directly but can invest their profits in other ventures that do earn foreign exchange and repatriate earnings in that way.

Many U.S. executives indicated that the policy was not all that elaborate really. A venture can only repatriate profits if it earns enough foreign exchange to cover them—period.

Perhaps the most difficult constraints confronting Chinese society are limited labor mobility and the social welfare system. Workers are assigned to work units or enterprises (known as danwei) where they have permanent employment assured—the so-called “iron rice bowl.” The link to the danwei is not only based on employment, but on housing, education, pensions, health care, and other key services provided only through the work unit. Chinese managers indicated that roughly two-thirds of the workers in their enterprises were involved not directly in production but in these other ancillary services of the enterprise.

The delegation strengths suggested that breaking the all-encompassing link between worker and danwei would both promote labor mobility to optimize use of available human talent and remove a heavy burden of overhead from enterprises. In our opinion, however, this is likely to require a profound change in the way services are provided in Chinese society. The government will have to develop national systems, or a market for these services will have to develop (with attendant shake-out of enterprises and dislocations while market prices are established). There seems little evidence that progress will soon be made in either area.

Capacity of the Chinese economy for change

Despite all the pledges of commitment by Chinese officials to reform and interest in Western economic models, we generally concluded that the capacity of the system for profound change and the likelihood of change along Western lines remain questionmarks. There was ample evidence of an entrenched “central planning mindset” even among those dedicating themselves to change. Bank of China Chairman Bu argued that when market signals are used, all enterprises produce or import the same goods, so planning is still needed. A number of officials argued that China's development represents a course no one else has tried and that the Chinese must “learn their own way” rather than simply adopt existing models. The Chinese also remain focused of the long-term goal of self-sufficiency in everything.

There was also a sense that others should adapt to China rather than the other way around. Despite all the evidence presented of the efforts still needed to attract foreign investment, the Chinese at times seem mesmerized by the great opportunities available in the Chinese market to the point of shortsighted discouraging the very western investment they believe they need.

PRCV officials remain unreceptive to negotiation of meaningful investor protections in a bilateral investment treaty arguing that U.S. investors already get better treatment than Chinese enterprises (15-30 percent taxation versus 50 percent) and should be satisfied, and that some Europeans have signed BITs on China's terms, so the problem must be the United States.

Even relatively minor requests run into a stone wall at times. Efforts by American businessmen to have the Chamber of Commerce accredited to Beijing and representing their interests have thus far been rebuffed. The Chinese argue that the business community should be satisfied because many have representative offices and the U.S. Council for U.S.-China Trade is accredited.

Institutions like the Chinese bureaucracy, with its 5,000 year history, was cited a major hurdle by U.S. officials and businessmen. Fragmented authority spread over a multiplicity of agencies is a major reason things simply do not happen.

The administered Chinese pricing system is another key constraint on the economy. Many if not most prices are set administratively and do not reflect production costs or economic scarcity. This applies to the exchange rate as well as to prices of production inputs like labor, land, utilities, etc. There has been some recent, limited experimentation with prices based on the balance of supply and demand rather than central planning, with resulting inflation of 8.8 percent in 1985. It is most interesting that the Chinese stated that they have set the same rate of inflation as a level they would like to duplicate in 1986.

A particularly damaging element of pricing policy is the practice of grossly overcharging investors for labor, land and other inputs to production. The profitability and therefore the attractiveness of investment in China are reduced by this policy in which labor charges of up to 5 times the local going wage are cited as common, apparently pegged to prevailing average rates elsewhere in Asia (without taking account of differences in infrastructure, education, etc.). Similar overcharging applies to the staging of trade shows and seminars. The government relies on this process to generate foreign exchange since the government lays claims to the foreign exchange and to the difference between prices charged and prevailing local wages and rents. PRC officials noted that all of these prices are subject to adjustment in the negotiated agreements between the investor and the government.

Both to American enterprises investing in China and to the PRC generally the lack of some key institutions is another important constraint. The private sector is very limited in size and restricted to small commercial and service enterprises. There is no private credit system of any kind, and the official credit system is very limited. The legal system is in the early stages of definition and there are few guideposts of legal precedent to go by. These concerns were underlined by "representative" horror stories from U.S. executives.

One businessman seeking a copy of local regulations under which his business was to operate was informed that the regulations were not published but that the local government offi-

cials could answer his questions and would inform him of any infractions or problems.

Businessmen also noted a Chinese penchant for unilaterally changing contracts negotiated with foreign investors if they appear more favorable to the investor than originally intended.

In sum it was clear to all members of the delegation that the Chinese often inflicted needless and counterproductive barriers, ranging from minor to major in nature. Until the various—and frequently conflicting—Chinese government bureaucracies realize the extent of this problem, it was our judgment that western businessmen would be greatly discouraged from attempting direct investment.

THE UNITED STATES ECONOMIC ROLE IN CHINA

The clearest message received by the delegation was that the Chinese welcome the expanding economic ties between the United States and China. They admire American technology and education and want to take advantage of as much of it as they possibly can. The Chinese welcome the various sectoral cooperation agreements that have been signed (telecommunications, science and technology, machine building) and the recently approved tax treaty as indications of a deepening bilateral relationship.

Key sectors

Chinese officials cited energy, transportation, communications, and electronics as key sectors for cooperation with the United States. These are areas in which the Chinese want to spur development and to which they would like to see U.S. technology applied. Several officials cited major Chinese purchases in these sectors: eight Boeing aircraft and more than 20 planes from McDonnell-Douglas; large General Electric locomotives; a great variety of computers.

There was only passing mention of Chinese use of U.S. military technology, and that reference was to the recently approved sale of avionics for China's F-8 fighter. People's Liberation Army (PLA) officials cited the small (\$5.2 billion) Chinese military budget as the driving force behind efforts like the F-8 upgrade to work with friendly countries to modernize China's army. In Baotou, the delegation also saw evidence of U.S. computer technology being applied to computer aided design of Chinese tanks. China argued that her army was a defensive force only, that its principle role was to fend off the Soviets and their allies, and that a strong Chinese army was a force for peace and in the U.S. interest.

At the center of Chinese interests in expansion of the Sino-American economic relationship is technology transfer. The Chinese want every U.S. export, every joint venture, to embody a major transfer of advanced technology. Aside from the (false) complaint about running a trade deficit with the United States, the only complaint heard from the Chinese on the economic relationship was that U.S. hi-tech products had been bought (especially computers) but the only limited transfer of technology had accompanied the sales.

Export controls

Developments in U.S. export control policy with respect to China have mirrored broader development in Sino-American political relations. In particular over the last several years, controls on technology and equipment, especially for items in widespread commercial use, have been gradually liberalized. In June 1983, President Reagan recognized China's status as a "friendly, non-allied country" in announcing his decision to shift China into export control "Country Group V." China joined most friendly countries of Europe, Africa and Asia in that grouping, although China remained subject to control by the Coordinating Committee (COCOM) in Paris, comprised of Japan and all the NATO countries except Iceland.

Revised U.S. export control regulations were issued in November 1983 establishing detailed technical guidelines ("green lines") for a range of products in seven categories (computers, microcircuits, semiconductor production equipment, computerized and electronic instruments, recording equipment, and oscilloscopes) which would routinely be approved for export to satisfactory end-users in China. Within the U.S. Government, license applications falling within the "green lines" required only Commerce Department (rather than interagency) review. However, these exports continued to be subject to review by COCOM.

In early 1985, the members of COCOM began discussion of steps to streamline approval of China cases that had become routine. A new policy was devised whereby as of December 15, 1986 products falling within guidelines drawn up in 27 product categories (somewhat broader than the seven categories under the 1983 U.S. policy) would no longer require COCOM review. New Commerce Department regulations were issued in late December. Even with this further liberalization, high technology exports to China remain subject to U.S. national security and COCOM controls, reflecting Chinese strategic capabilities unique among friendly countries in Group V.

The progressive relaxation of U.S. and COCOM controls has resulted in an expanding volume and higher level of American technology exported to China. Between 1982 and 1985, license approvals rose from 2,020 to 8,637 while dollar value of approvals increased 1000 percent from \$500 million to \$5.5 billion. U.S. exports of computers and scientific instruments to China increased by two-thirds from \$280 million to \$470 million between 1984 and 1985.

The delegation focused considerable attention on the impact of U.S. and COCOM export control regulations on the flow of technology to China. Several Chinese officials brought up the issue of U.S. controls and cited continued controls over technology flows to China, especially continued strict controls on high tech items, as incompatible with the friendly relations existing between our two countries. At the same time, the Chinese seemed generally aware that export control policies as applied to China had recently been further relaxed and expressed appreciation for this change.

Despite this general awareness of U.S. export control policy by senior officials, Chinese engineers and enterprise managers with whom the delegation met seemed considerably less informed. Even

Chinese scientists and engineers in high technology enterprises were short on specifics when asked about their priority requirements for advanced U.S. technologies and were unclear on their availability under current export control regulations.

Discussions with government officials, including the Director of the Shanghai Municipal Science and Technology Commission, produced no evidence that export controls were impeding Sino-American trade and economic relations outside of specialized high tech areas.

At the low technology plants the delegation visited (Baotou tank factory and Hudong shipyard), the only evidence of U.S. technology was several computers for computer-aided design and one large automatic boring machine. When asked if any U.S. high technology was needed and unavailable, the response was generally that if they needed American technology, it was accessible (relatively small computers). It seemed clear that these views applied only to non-military hardware and electronics.

Even at the high tech sites visited (Lishan Microelectronics and Xin Zhonghua Machinery Factory) where very advanced computer, semiconductor, and rocket technologies would have been useful, it is not clear that there were U.S. technologies being actively sought by the enterprises that were blocked by controls. It was not clear that the managers fully understood that was and was not available under the new U.S. export rules or were exploring the issue.

At Xin Zhonghua, the Long March 3 rocket, China's orbital launch vehicle, is produced. It is a three-stage rocket capable of placing a satellite in geo-stationary orbit. Given U.S. experience in rocketry, this is clearly an area in which U.S. technology would have been a leader. However, there is no cooperation between the United States and China in space technology, and the Chinese engineers reported that no U.S. technology was part of the system. In fact, they have given so little thought to the concept of purchasing U.S. technology that they were hard pressed to name a single item of U.S. rocket technology they would like to buy, although they promised to think about it and send a list.

At Lishan Microelectronics, the chief engineer was American-educated and formerly employed in the United States, and had a clear if dated understanding of U.S. export control policy. His factory was capable of producing elements for advanced microchip production (chromium blanks with tolerances below 2 microns) in small quantities and of producing radiation-hardened chips, with a small amount of overall output sold in the military. However, production quality and volume is limited to quality control and non-automated production line.

The main output of the factory is small microchips (8 and 16 bit) and color TV integrated circuits (80,000 pieces annually) and small quantities of computer peripherals, especially floppy disk drives. The factory is principally pursuing expanded production of peripherals and color TV ICs in hopes of capturing the 200-million IC Chinese market from Japan, in addition to exporting to other Asian countries. However, the chief engineer also had interests in further developing the higher end of the technology scale.

He looked to the United States for advanced mask making, sputtering and coating equipment, but did not appear to believe it would really be made available. A review of the new China regulations with Commerce Department staff indicated that while these are clearly areas in which COCOM review is required, it is not necessarily the case that his requests would be denied as he anticipated. The more interesting feature of his comments was the allegations he made about export of COCOM-controlled technologies to China without a license by Japan and several European countries. He pointed out an integrated circuit assembly line purchased in 1980 from Japan which he claimed was sold in contravention of COCOM, and indicated that Japan was willing to sell an advanced electron beam generator this year again against COCOM rules. He also pointed out a sputtering machine bought from the Swiss in 1978 and a micro-vapor deposition unit bought from the Dutch sister-firm of a U.S. company in Phoenix; again, both COCOM controlled machines.

His argument was that Chinese access to U.S. goods should be relaxed since China already has access to Western advanced technology despite COCOM controls. The limited descriptions of the equipment in question brought back from the China trip and discussed with the Commerce Department indicated at least the possibility that controlled items were sold to the PRC without license.

Opportunities and problems of United States joint ventures in China

As mentioned earlier in the report, the Chinese appear to have a strong preference for dealing with Americans over the Japanese. This is because even though Japan puts a lot of time, effort, and manpower into their sales effort over a long period of time, they do not set up joint ventures and they do not share technology. China is hungry for technology and American firms have been scoring points with the Chinese by putting their money and know-how into the country. It may well be that the willingness of American firms to stay the course of building a joint venture will give the U.S. a firmer footing in China than all of Japan's massive sales effort.

The costs of this strategy for U.S. firms is not inconsequential. As mentioned in the discussion of China's policy and development problems above, joint venture partners face stringent requirements to earn foreign exchange in order to repatriate profits, limited legal protections, overpricing of inputs to production, a limited base of with little hope of significantly tapping the Chinese market. Many of the businessmen meeting with the delegation reported that their operations were marginal in terms of profitability.

At the same time that China presents some daunting problems, American business appeared to be creating some problems for itself by failing to study and understand the Chinese decisionmaking process. Cases were cited of Americans relying too heavily on their joint venture partners to deal with the system rather than asserting the American leadership necessary to successfully manage and plan their joint venture in China. This practice results in underemployment of American management skills that are an essential ingredient for success and for technology transfer to China.

The sectors and technologies China is trying to develop are those in which there is heavy involvement by small and medium-sized U.S. high technology firms. However, the Chinese are concentrating on attracting larger firms and larger projects and are therefore missing key opportunities for production of software, computer peripherals, etc. that smaller firms produce. China would do well to focus some of its investment promotion efforts on such firms, as would the U.S. Government.

POTENTIAL SOURCES OF FRICTION

Despite the clear evidence of progress being made in Sino-American relations, there is considerable scope for improvement before the relationship truly represents ties typical between friendly, non-allied countries. The delegation received small reminders of the mistrust that is still to be overcome by the Chinese in their decisions to forbid photos at the Baotou tank factory (with its 1930s production technology) and the Xin Zhonghua factory (where the delegation viewed a disassembled engineering model of two-thirds of a rocket). While these decisions were only minor irritants, they are clearly incompatible with good relations between countries that are now routinely sharing military and advanced civilian technology and exploring areas for further cooperation.

The political relationship has been characterized as solidly based on common interests with regard to the Soviet Union. However, a decision by the Chinese to vigorously oppose U.S. interests in other areas of the world or to emphasize problems over Taiwan could set back the relationship.

In the economic sphere, the trade relationship is the key potential trouble spot in Sino-American relations that will have to be managed carefully in the years ahead. Foremost among the issues in this area is the rising level of Chinese textile exports to the United States. However, over the longer haul the Chinese drive to produce consumer manufactured goods, in many cases through U.S. joint ventures, could begin to affect U.S. overseas markets and the U.S. market as well.

Textiles

There were several discussions of bilateral trade balances that touched upon the delicate issue of rapidly increasing textile exports to the United States. The Chinese argue that the U.S. market should be fully open to them since their exports to the United States are just over one percent of U.S. exports and totally un consequential. The delegation members rebutted these arguments by pointing out that Chinese exports are very concentrated in textiles and apparel which is both labor intensive and heavily impacted by imports. Chairman Heinz emphasized that when a U.S. plant fails due to an import surge, people in small towns wind up unemployed with few alternatives available.

The delegation repeatedly pointed out that the U.S. economy is one of the most open in the world, and that the U.S. is happy to share the growth of its market with others. However, China's first quarter 1986 exports of textiles are nearly double the level of first quarter 1985, and China has moved from fourth exporter of textiles

to the United States to first. The delegation noted that, as in the area of international relations, this is an issue on which the United States looks to cooperation from the Chinese as a measure of the extent to which they value the bilateral relationship.

POLICY CONCLUSIONS

The general conclusion of the delegation's trip was that China is pursuing a relatively friendly, non-aligned policy line with regard to the United States, and that there is a convergence of political interests between the two countries with regard to the Soviet Union's actions in Asia.

To support the positive elements in the Sino-American relationship, the United States should maintain a military presence in the Western Pacific to support regional stability, and take steps to support the economic reform and liberalization of Chinese society in order to encourage China to align itself more closely with the West. These steps would include:

Continued official bilateral efforts to negotiate an investment treaty and to fully involve the PRC in international agencies like the GATT.

An increased U.S. business presence to expand the bilateral trade and investment relationship and to promote Chinese acquisition of Western management concepts with a commensurate and necessary deemphasis of control by government bureaucracy.

Ranking U.S. officials and members of Congress should make greater efforts to assist U.S. businessmen in establishing joint ventures in the PRC.

Greater exchanges of mid-level civilian and military personnel as well as educational exchanges of both students and faculty.

The U.S. should support Chinese access to Western technology, but should:

Ensure the COCOM controls are enforced by making special efforts to carefully police Japanese sales to China to prevent circumvention of controls; and

Make clear to the Chinese that further relaxation of the current limits on technology transfer depends on:

a. Greater Chinese understanding of and support for U.S. efforts to contain Soviet expansionism in the Middle East, Africa and Latin America;

b. Peaceful resolution of differences with Taiwan; and

c. A substantial improvement in the climate for U.S. business investment.

U.S. business interests should be generally more aggressive in pursuit of business opportunities in China. They should not rely on joint venture partners but should learn the Chinese system and take control of their destiny. They should also be more aggressive in seeking help from government officials and members of Congress in opening doors, etc.

The Chinese correctly attach great importance to the role of foreign investment in promoting the more rapid growth to which they

aspire. However, they appear intent on pursuing policies designed to thwart a closer relationship to the West and to turn off the flow of Western capital and technology to China. Their growth plans are doomed to failure unless the Chinese government shifts its policies in two key areas.

First, with respect to investment, Chinese leaders must stop deluding themselves that investing in China is too good an opportunity for Western firms to pass up. China is a difficult place to do business at best, and prospects for earning a reasonable rate of return on investment there will remain poor unless the Chinese choose to make potential investments more attractive.

The first step is recognition by the Chinese that U.S. investment is primarily in China's interest and that, under present circumstances, U.S. investors require incentives to attract them to China.

Within the sectors to which the government attaches priority for investment, the Chinese should recruit U.S. businesses that have the technology they want, including small business.

Business conditions, market access, pricing of inputs to production, access to the labor market, and policies on repatriation of profits must all be improved. In this regard, more experimentation with special economic zones and other such innovations would be a mechanism for creating a conducive investment climate.

The Chinese must provide reassurance wherever possible that theirs is a long-term commitment to economic reform and foreign investment, acknowledging that this course will inevitably liberalize and profoundly change the political and economic climate in the country.

The second and related area where change is needed is China's present cavalier attitude toward U.S. foreign policy interests. China cannot expect support and cooperation from the United States on matters important to her economic development while the Chinese government polishes its Third World credentials by lambasting the United States on issues important to U.S. foreign policy interests. China appears to view her criticism of U.S. actions to stop Soviet expansionism in Central America or Soviet support for terrorism in the Middle East as China's private business, divorced from the overall Sino-American relationship. This is clearly wrong, and China must realize that an expanding bilateral relationship requires Chinese cooperation with and understanding of U.S. interests on a broad policy front, not just on matters of interest to China.

JOHN HEINZ.

DELEGATION OF THE U.S. SENATE

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